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By late summer, there will be no question that the United States is deep in a recession. The global economy will be in its own, snowballing recession. Financial problems will be erupting at home and abroad. Deflation worries will be displacing inflation fears. Many people who now take for granted a swift Fed rescue of the economy will be questioning the ability of the central bank to arrest the economic decline.

The Levy Institute, *Forecast*, May 29, 2001

PUSHING ON A STRING

For the time being, the markets and the media are fixated on two favorite themes: the dismal tale of economic weakness in Europe, and the merry tale of the impending V-shaped recovery in America. Currency as well as U.S. bond and stock markets reflect a resilient faith that the American economy's "new paradigm" revolution, with its accelerated pace of productivity and profit growth, will soon reassert itself, once the excessive inventories, in particular in the high tech sector, are liquidated. In a speech to the Economic Club of New York, Fed Chairman Alan Greenspan espoused his cheerful view: *"There is still, in my judgment, ample evidence that we are experiencing only a pause in the investment in a broad set of innovations that has elevated the underlying growth rate in productivity.*"

Yet resilient confidence in the new paradigm revolution is not the only plank of optimism in the United States. The other one is unbridled faith in Mr. Greenspan and his infallible magic to restore economic growth whenever at risk with lavish liquidity injections. While skeptics tend to interpret his unusually aggressive interest rate cutting as a sign of panic and desperation to do everything necessary to bring back the bubble, the consensus rather takes it as a sign of determination to maintain "strong, healthy growth." Five rapid-fire cuts within just five months have slashed the Fed funds rate to as low as they were in May 1994. Nothing else matters, not the ominous speed and shape of the downturn or even the absolutely disastrous profit data.

It is, of course, true that there is always quite a lag between changes in interest rates and noticeable changes in the economy's behavior. But considering the extraordinary scale and speed of the rate cuts, some first effects ought to have shown by now. However, not only have they failed to prevent further economic weakness, most peculiar and most ominous is their miserable failure to lift at least the financial markets. On Jan. 2, the day before Mr. Greenspan started his barrage of six rate cuts by 2.75% altogether, the Dow index stood at 10,646.15, the S&P 500 at 1,283.27, the Nasdaq at 2,291.86 and 10-year Treasury yields at 4.92%. On June 30, the Dow was at 10,502, the S&P 500 at 1,224, the Nasdaq at 2,162 and 10-year Treasuries yielded 5.40%.

Booming stock and bond markets have preceded every economic recovery. The normal sequence in the business cycle is: booming money - booming financial markets - economic recovery. The only aggregate presently booming is the broad money supply (M3). What is the source of all this money? What are the economic or financial processes involved? We shall explain why this rampant money creation has so little or virtually no effect on the economy and the markets.

Looking for the most reliable economic indicator, we recommend profits. They are far more than just an economic indicator. By directly stimulating or retarding investment spending, they are really the primary moving force behind the business cycle. Rising profit expectations are the absolutely indispensable condition for economic recovery. The signs of an investment collapse are everywhere, particularly in the steepest and most rapid slump of profits in the whole postwar period. Although muted by several factors, domestic nonfinancial

profits in the first quarter fell 5.1% from the fourth quarter of 2000 and 14.5% from a year earlier. This compares with nominal GDP growth of 5% year-over-year. S&P after-tax earnings per share fell 31.3% from a year earlier and operating earnings 2.1%. Manufacturing profits are at a six-year low. Profit margins are at their lowest level in seven years. Only false optimism about the economy's impending recovery has prevented a worse rout in equity markets.

Waiting for the U.S. recession, essentially showing in a decline in real GDP, seems to resemble the wait for Samuel Becket's Godot. Well, Godot never arrived. In contrast, the U.S. recession will definitely do so. While economists and investors have cheered the Fed's sharp rate cuts and the fact that GDP has not yet dipped into negative territory, the unfolding downturn is, nevertheless, manifesting very ominous features that negatively distinguish it from all prior postwar cycles.

The false optimism is clearly shaped by the regular postwar experience with recessions and grossly inflated faith in Mr. Greenspan. Never before have rate cuts by the Fed failed to accomplish prolonged stock market rallies and economic recovery. Unfortunately, there are compelling reasons to assume that this time is the first, great exception from this rule. *"Men, like dogs,"* borrowing from John Maynard Keynes, *"are only too easily **conditioned** and always expect that, when the bell rings, they will have the same experience as last time."* The decisive distinction, readily ignored, is that the economic conditions propelling the U.S. economy's present downturn have nothing in common with the cyclical fluctuations of the past, reflecting just short-run inventory corrections.

As we have repeatedly stressed, the difference is twofold. One is the downturn's unusual speed, and the other one is its unusual shape. As to its speed, violent boom turned to violent bust within little more than six months. Over less than a year, from the first half of 2000 to the first quarter of 2001, real GDP growth has tumbled 4 percentage points, from 5.2% to 1.3%, both at annual rates. And while past downturns were centered in a rundown of excess inventories, this one reflects collapsing fixed investment, a drastic slowdown in consumer spending and, worst of all, unprecedented carnage of corporate profits. An inventory correction has just begun.

It keeps us wondering and wondering how the Wall Street gurus manage to preserve their complacency about the U.S. economy's state in the face of the shockingly bad economic and profit data. They have, of course, tremendous experience in duping people, their customers and themselves. American statistics about economic activity are the most comprehensive and most up-to-date in the world, yet it strikes us how little of all that information is actually finding its way into recognition and public discussion.

THE DANGER SPOTS

Trying to judge the economy's further development, scrupulous scrutiny of underlying conditions is clearly incumbent. Yet we see very little of it. As we have stressed many times, understanding the specific pattern of the downturn is crucial for judging both its course and its implications. Regardless of manifest, contrary evidence, the consensus sticks to the deceptive version of an inventory correction. Announcing its last rate cut, the Federal Reserve declared in its associated statement that the inventory correction was "well advanced." Actually, inventory correction in the first quarter of this year has just started with a paltry decline by $7.1 billion, after a $60.5 billion increase last year. The inventory sales ratio for businesses as a whole was at 1.37 in March, after 1.32 a year ago.

Profits are the most important issue and require utmost attention. Remember: The aim of production in the capitalist economy is the pursuit of profit by businessmen. "Take this away and the whole process stops" (Keynes). Within just two quarters, profit margins fell in Q1 to their lowest level since early 1994. Here, too, it is amazing how little attention the profit drama finds.

The profit carnage has come as a shock to corporate managers. But the other important thing to see is that the trumpeted "profit miracle" of the late 1990s never happened. The story was completely bogus. After-tax, nonfinancial profit growth from $403.8 billion in 1995 to $527.3 billion in the fourth quarter of 2000 works out to an average annual increase of 5%, in current dollars. If you deduct the inflation rate, real corporate earnings

grew by no more than 2-3% per annum. For a booming “new paradigm” economy, this was worse than miserable. With the weakening economy, badly disappointing profits have suddenly turned into collapsing profits. By the way, we presume that these aggregate numbers take no account of the big losses that have accumulated in the high-tech sector over the years.

The immediate effect has been the worst investment bust in the postwar period. Growth of fixed investment in the course of 2000 has plunged straight down from 16.4% in the first quarter to –0.9% in the fourth quarter. Within the aggregate, investment in equipment and software dove over the year from 20.6% to –3.3%. But since the brunt of the profit squeeze has been on undistributed profits, corporate cash flow is also down. The ratio of cash flow to nonresidential fixed investment, at 72.2%, is at its lowest level since the third quarter of 1982. During 1991-99, this ratio has averaged 84%, fluctuating between 74% and 94%.

Considering the foreseeable influences on profits, it is beyond any question that their fall is sure to steepen in the course of the year, intensifying the investment bust with major negative consequences for consumer income and spending. Orders and shipments in particular for ITC goods keep sliding. In April, such orders fell by 10.3% in nominal value and shipments by 6.9%.

THE KEY TO CAPITAL FORMATION: SAVING

Gross neglect of these important negative facts is the one thing that surprises us about the public discussion of the present U.S. economic downturn; utter lack of understanding and appreciation for the inherent macro financial and economic issues throughout the financial community is the other one. Elementary insights into economic processes that have been accepted by all schools of thought ever since systematic thinking in economics started more than 200 years ago are unknown, discarded or even put on their head.

Compared to Europe, American economics has traditionally been short of theory and long in statistics. Yet today it is virtual anarchy at the macro front. Protracted runaway credit and money expansion, negative personal saving, a massive shift in resource allocation towards consumption and a balance-of-payments deficit of monstrous size — all these egregious financial and economic maladjustments have zero relevance for American policymakers and economists. Rather, the New Theory of the New Economy elevates them to hallmarks of economic dynamism.

For ages, economists of all schools of thought have regarded the equilibrium between saving, credit supply and capital investment as the central problem in economics. No knowledgeable economist would have equated rising stock prices with *“wealth creation.”* The crucial difference between national capital wealth and personal wealth used to be well-known to everybody. **As formulated by David Ricardo, *“capital is that part of the wealth of a country which is employed in production.*** ” And these economists also had a clear perception that there is but one single way how such (productive) capital can be created: through domestic saving. **Adam Smith postulated *“that parsimony, and not industry, is the immediate cause of the increase of capital.”*** In his book *Keynesianism vs. Monetarism*, Professor Charles Kindleberger quotes a remark of Adolphe Thiers, French Finance Minister, 1865-7, in a speech to the Conseil Supérieur: ***“It is impossible to create more capital than society creates through savings.”*** Quoting a more recent American economist, Professor J. Laurence Laughlin, *Credit of the Nations*, 1918: ***“Credit does not create capital. Capital functions as economic goods are given over mainly to productive uses, and originates through saving.”*** In the same vein, by the way, it used to be commonplace knowledge that credit growth in excess of available savings is the source and the measure of excessive consumption, investment and speculation.

What is it that caused the old economists to rank “saving” so high in their economic model? In short, its impact on the economy’s resource allocation. To the extent to which people consume less than their current net income, they provide the factors of production that are required for the production of plants and equipment. This release of resources for capital formation is saving’s vital macroeconomic function that accrues exclusively from saving out of current income. This has always been the all-important macro aspect of saving, and that’s what Adam Smith meant with his statement that parsimony, and not industry, is the immediate cause of capital. Ultimately, the rate of saving sets the limits to non-inflationary capital investment. And that’s also the

compelling reason why official statistics worldwide treat only saving from current income as "saving."

This insight into the macroeconomic essence and function of saving used to be elementary knowledge in economics. The first to have completely lost sight of it are today's American New Economy apostles. Equating realized capital gains in the stock market with saving reveals total macroeconomic illiteracy. Plainly, they have the exact opposite effect on the use of resources: To the extent that wealth effects boost consumer spending, they decrease capital.

The crucial, precarious aspect of the negative saving rate is that it reflects an unprecedented, bubble-related escalation of consumer spending. If the Fed's drastic easing fails to revive the bubble, the massive overspending by the consumer will burst just like the massive malinvestment of businesses in the high tech sector.

MACRO VERSUS MICRO

Thinking it through, we have come to realize the crucial, distinguishing feature between our approach and that of the American consensus. It's macro contra micro. From a micro perspective, that is, in the view of an individual, a negative saving ratio may appear irrelevant if offset by capital gains; but from a macro perspective, it indicates a gross misallocation of resources involving a severe economic maladjustment. From a micro perspective, the American shareholder value model with its shorter time horizons and its heavy leaning toward cost-cutting, restructuring, downsizing, mergers and acquisitions may appear the philosopher's stone in improving corporate efficiency and profitability in the fastest possible way. From a macro perspective, it's complete economic nonsense because these practices will essentially occur partly at the expense of new capital investment, which is the most important condition for profit creation and long-term growth. Wall Street has completely corrupted economic thinking.

We have always contended that all this is misguided and narrow-minded microeconomics in utter disregard of inherent, adverse macro implications. After all, it is now plainly evident that the proclaimed productivity and profit miracles were pure bogus. Corporate profitability during the first half of the 1990s received a major boost from sharply falling interest and depreciation charges. Once the two benefits exhausted themselves in 1995, corporate profits actually began to underperform the economy. The bullish argument for profits that deceived most people was the alleged tech-driven acceleration in productivity growth. Deriving largely from the hedonic price indexing for computers, the productivity miracle was in reality just as phony as the profit miracle.

All the glib talk about the wonders that the postulate of maximizing shareholder value has done to the U.S. economy could never shake our conviction that, from a macro perspective, only one condition is able to generate true, lasting material prosperity: saving and capital accumulation in tangible, productive assets. Unfortunately, that's precisely what the new American stock market capitalism with its preference for mergers and acquisitions, restructuring, downsizing and cost-cutting inherently neglects. All this is no substitute for capital investment and new production. The old economists, in contrast to today's economists, were well aware of the potential, grave fallacies in the micro approach, emphasizing it by a widely used specific expression: ***the fallacy of composition.***

DISTORTED INVESTMENT PATTERN

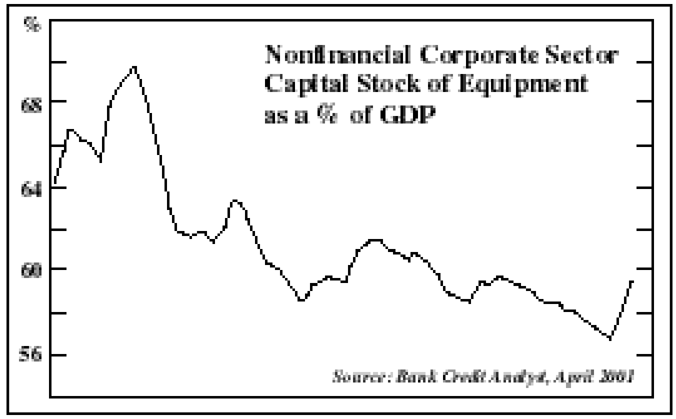
The essential point of this term is that what is advantageous for a single firm may be unfavorable for the economy as a whole. If one corporation cuts wage costs and downsizes its plant, it may be able to boost its profits; but once all businesses follow suit, the result is just the opposite as broadly declining overall business revenues squeeze profits. All the strategies that the shareholder value model recommends for profit maximization suffer from this "fallacy of composition." It has its glaring evidence in the miserable profit performance of the last few years.

It is high time to take notice of this profit malaise and ponder its causes. Sticking to the macro approach, we identify two main sources of profit weakness: lagging net investment and the soaring U.S. trade deficit.

Measured by gross investment as a share of GDP growth, the U.S. economy in the past few years has

experienced its greatest investment boom in history. This is quite misleading, however. Due to outsized investment in short-lived high-tech equipment involving high depreciation charges, net investment has remained rather low. As a result, the corporate capital stock of equipment and software has in most years continued to decline in relation to GDP.

Here comes the snag: It is net investment, and only net investment, that adds to national income and to the economy's capital stock. Poising the soaring foreign indebtedness against the poor net investment ratio, it emerges that the United States is consuming capital. It needs more and more investment just to make up for the rising depreciation charges. Ultimately, America is selling its factories in order to pay for its overconsumption. Nothing remotely like this has ever happened before, except in war.



Very low net investment is the one problem; an extremely lopsided pattern of fixed capital investment is the other. For years stellar increases in high-tech investment have strikingly contrasted with protracted sluggishness of investment in industrial equipment. Manufacturing capacity growth, except for high-tech, has been very low, suggesting that the soaring trade deficit results not only from excessive domestic spending but also from grossly lacking investment in industrial capacity of the Old Economy. In reality the big capital investment numbers camouflaged a gross misallocation of capital.

TWO MAJOR PROFIT KILLERS

Implicitly, the poor profit performance calls for an explanation. The ready, comforting consensus recital is the low inflation rate. That is another delusion. Since 1995, the index of consumer prices is up 16%. Over the last year, it has been rising at an annual rate of 3.4%. This compares with a simultaneous increase in nominal wages by 21%. Taking the reported overall gain in productivity of 17% into account, this ought to have made for strong profit growth. It didn't, because the big productivity gains that accrue from the massive deflation of computer prices add nothing to profits, being measured in current dollars.

Assessing profit prospects, we resort primarily to probing the specific, macroeconomic flows that generate profits, and they are telling us that the U.S. economy is in for the worst postwar profit squeeze that is not just cyclical but structural.

Using this flow method, consider that aggregate profits represent the difference between aggregate business revenues and aggregate business expenses. Looking at the business sector as a whole, capital spending is income for the producers of the equipment but not expenses for the purchasing firms because they capitalize these expenditures in their balance sheets. They are gradually expensed with the depreciation charges.

As a result, net investment is typically the largest and most important profit source of businesses. The problem with the new high-tech investment is twofold. One is that it involves rather moderate amounts in current dollars that alone add to profits. And the other one is the immediate, high depreciation charges. The resulting low net investment ratios are a main reason for the economy's dismal profit performance.

The other great profit killer is the phenomenal rise of the trade deficit. It hammers U.S. business profits in two ways: first of all, it puts a lid on the domestic price level, as imported goods add substantially to their domestic supply at rather stable prices. Second, the soaring imports divert spending power and income away from Corporate America to foreign producers. As most of that money inherently comes from the U.S. domestic wage bill, it puts Corporate America into a savage profit squeeze. More plainly, American producers have the wage costs, and foreign producers have the revenue from the spending of the wage money.

THE BIGGEST RISK OF ALL…

Our excursion into the history of economic thought about the all-important role of saving in creating capital has, as a matter of fact, a specific reason. There was a recent article in the Bank Credit Analyst on the U.S. negative saving ratio that met with quite a lively response. It was titled "There is Not a Problem of Low U.S. Savings." The author asks: *"Are U.S. consumers heading blindly like lemmings over the financial cliffs?"* His answer: *"The official data are very misleading and bear little relation to how most consumers would regard their saving…From an individual consumer's point of view, realized capital gains are part of income…Beware of Armageddon forecasts based on the view that the U.S. savings rate needs to rise massively.*"

In other words, the author's measure of saving is what "most consumers would regard their saving." Alfred Marshall, the father of modern microeconomic theory, once said that in the final analysis, microeconomic theorizing amounts to little more than amateur psychology. American economic policy has, indeed, degenerated into confidence-building tricks with the obvious aim to sustain the unsustainable spending bubble. Negative savings are supposedly no problem because the heavily indebted consumer is happy with the capital gains he has accumulated in the stock market and on his family house. Since many financial experts are telling him that these wealth effects make saving from current income unnecessary, this is his understandable conviction. A responsible economist, however, ought to warn him that his stock market gains are illusory wealth that is bound to perish with the perishing business profits.

Looking at the struggling U.S. economy, two crucial questions come to mind: first, can the U.S. economy really prosper in the long run with negative personal savings and the monstrous, chronic trade deficit? And second, is it at all feasible that the consumer prevents recession?

…IS THE NEGATIVE SAVING RATE

Turning to the first of the two questions, our short answer is: Impossible. From a macro perspective, living standards can be increased in two diametrically different ways: The normal one is for the long run and occurs through *capital accumulation*, that is, through saving and capital investment. The other one, the abnormal one, is for the short run and occurs through *capital consumption*, that is, through dissaving and massive borrowing, domestic and foreign, for consumption. America is practicing this second combination with abandon. Its hallmarks are a rising share of consumption in GDP and soaring domestic and foreign indebtedness. Putting it a bit more provocatively: Today's Americans will bequeath to their children a mountain of foreign debts and a ravaged domestic capital stock.

During the last few years, consumption gained its highest share in GDP growth in the whole postwar period. In 1999, it accounted for 84% and in 2000 for 71.6% of the increase in real GDP, and since the third quarter of last year, consumption exceeds total output.

Again, there is a micro and a macro aspect to this development. The micro aspect concerns the financial ability of the consumer to sustain his spending. In this respect, we hear and read far too much about consumer confidence and far too little about the miserable objective financial conditions and prospects confronting him. His false optimism may help the economy in the short run, but his finances are squeezed from all possible sides: job cuts involve income cuts; record-high debt service is now impacting shrinking income growth; falling stock prices are draining his financial wealth. Consider that he supplemented his increase in current income by $492 billion in 2000 with $566 billion that he borrowed. He spent more than twice his current income. To lure this financially strapped consumer into still higher indebtedness is as stupid as it is irresponsible. At best, it borrows a little time, but at the price of more trouble later. Expecting him to sustain his spending in the present environment is absurdly unreasonable.

A STRUCTURAL CRISIS

First of all, it is wrong to depict the American consumer as unflinching in this climate. He has in reality quite sharply retrenched. In real terms, his spending has slowed to a growth rate of a little over 2%, annualized, from 5.3% both in 1999 and 2000. For consumer spending that's an unusually sharp decline. Besides, we suspect a

big distortion due to flawed seasonal adjustment. Of its total growth in the first four months of 2001, almost three-fourths happened in January. Recent monthly spending increases of about $11 billion compare with average monthly growth by $26 billion in 2000, all in chained dollars.

The macro aspect of the negative saving rate concerns the inherent repercussions to the allocation of resources in the economy. It's the aspect on which the Austrian school focuses.

We have always warned that the plunge in the personal saving rate is the U.S. economy's single biggest macroeconomic problem. Yet a cottage industry of researchers has been busy discrediting the conventional measure of saving. It is their most absurd argument that the consumer's balance sheet is in excellent shape as stock prices have risen faster than debts. These people even fail to realize that this burst of phony paper wealth is precisely the key problem. It was the exploding asset bubble that lured the consumer into his conspicuous borrowing and spending binge. While a lot of that bubble wealth has meanwhile been wiped out, the greater part is still in existence — destined to follow suit in due time with the ultimate effect of restoring a reasonable personal saving rate.

We come to these bubble-related structural distortions in the economy that spell the crisis. In the U.S. case, they are of a magnitude that definitely spells a prolonged, very painful adjustment process. The point to see is that the credit-fuelled distortions in the demand structure inherently distorts the whole production and investment structure in the same direction, essentially implying huge malinvestments. The biggest malinvestments were clearly in high tech, both on the part of producers and users, and in the retail sector.

What basically happens during the crisis is that the economy returns to its longer-term pattern of resource allocation between consumption and investment, which the consumer decides through his saving ratio. It has taken years to build the existing structural maladjustments into the U.S. economy, and it appears highly unlikely that they will be purged within a few months. What's more, since too loose money has caused them, still looser money is hardly the appropriate remedy.

What rate of saving will private households in America return to after the widespread loss of their paper wealth? What will it be…2%, 3%, 4% of disposable income or even higher? In any case, it will subtract hundreds of billions of dollars from consumer spending. The consumer-spending bust will join the capital-spending bust. It is too frightening to think this through. In this light, Mr. Greenspan's panic is all too easy to understand. It will take a miracle to prevent this from happening.

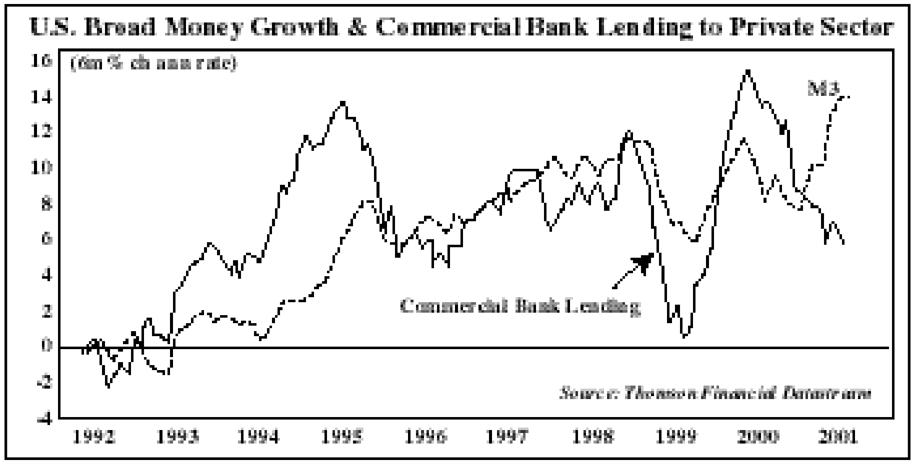
Pointing to the consumer's threatening financial malaise, we are not suggesting that Corporate America's balance sheets are in better shape. Obsessed with the idea of maximizing shareholder value, Corporate America recklessly ravaged its balance sheets during the boom years by repurchasing its own stock in record amounts at record-high prices. Remarkably, it's the diametric opposite of what Corporate America did in the late 1920s. When bond yields declined and the stock market boomed, corporations took full advantage of the situation and strengthened their balance sheets by maximizing the issuance of stocks and long-term bonds. Borrowing from Joseph Schumpeter: "*As far as ready money is concerned, many concerns were creditors' rather than debtors'. They entered the great depression with a financial outfit which was nothing short of luxurious.*"

THIS TIME IT IS DIFFERENT FOR MONETARY POLICY

Yet one thing, at least, seems to be to the great liking of equity investors in America, and that's the monetary aggregates. After the Fed's five half-point rate cuts, the two broader components are simply booming. Since the start of the year, the annual rate of growth in M2 has accelerated from 6.5% to 10%, and in M3 from 8.5% to more than 13%. Rarely, if ever, has money creation been running so vastly in excess of nominal GDP growth, being lately down to 3%. For most observers, the booming money growth demonstrates the initial success of monetary easing. For them, it is game, set and match as far as the economy's recovery is concerned. Never mind the endless stream of awful economic data; never mind collapsing profits. It is only Mr. Greenspan and his monetary magic that matters.

True, it has worked ever since 1987. But looking at the sources of this rapidly accelerating money growth,

we have to warn: this time, it's different. Very different. To quote Schumpeter on the issue: "*It is obvious that effects of increases in the quantity of money will be entirely contingent upon the use to which the quantities are applied, and the way they take through the economic organism…whether they finance primarily consumption or production, whether they serve purposes which will increase the social product or purposes which will not*." In other words, it is not the money creation as such that matters. Trying to assess its impact, we have to concern ourselves with the pattern of expenditures that it fuels.



Ever since the early 1980s the money supply in the United States and in many other countries has grown considerably faster than GDP, greatly to the liking of Wall Street and equity investors, hoping and arguing that the "excess" money would make its way largely into stock markets, propelling them upward. Well, it worked for almost 20 years. The prodigious wealth effects were, in turn, a powerful source of support for the great consumption boom since 1995, when the U.S. bubble went completely out of control.

To repeat, however: This time, it is very different. There are two features that radically differ from past experience and ought to set alarm bells ringing. The one is: For the first time in the postwar period, soaring money growth has been coinciding with a plunge both of the stock market and of GDP growth; and the other one is an unprecedented, marked divergence between money growth from bank lending and from money market funds.

During the five months to end-May, M3 has skyrocketed $400, or 13.5% at annual rate. And what are the effects? The first compelling reason to register disastrous failure of the Fed's easing is that six months of big rate cuts have completely failed to reinvigorate the financial markets. Lower short-term rate are also supposed to reduce long-term rates and boost stock prices. It means that the key components of the transmission mechanism between monetary policy and the economy are flatly paralyzed. In 1929, by the way, when the Fed cut its rates in response to the crash, the stock market instantly staged a big rally, recovering within four months around 50% of its prior losses until March.

While Wall Street and investors like to regard the Fed's rate cuts and the rampant money growth as the infallible harbinger of the economy's and the stock market's impending rebound, it should rather alarm them by now that such runaway money and credit creation displays zero effects not only on the economy but also on the markets.

The fact is that, contrary to prevalent simplistic thinking, the link between interest rates, money growth and actual spending of the money is anything but straightforward. Availability of money and credit is a necessary but by no means sufficient condition for spending. At all times, there are other factors at play when consumers or businesses decide to spend available money. Think of the wealth effect and job and income expectations in the case of the consumer, and of profit expectations in the case of businesses. In the past few years all these influences have worked vehemently in favor of spending. But that's over. Now, there are overwhelming reasons to restrain spending.

MONEY VELOCITY BREAKS DOWN

During the first half of 2001, M3 has grown $400 billion, or 13.7% at annual rate. To put this into historic perspective: This money growth of just *six months* compares with overall broad money growth of $416 billion,

or 2.4% at average annual rate, during the *five years* from 1990-95. During the following five years, between 1995-2000, broad money increased $2,470 billion, or 10.6% at annual rate. The present broad money growth of 13.7% has only been exceeded (14.6%) in the two top inflation years of 1971-72.

Clearly, the link between money growth and the economy and the markets has broken down, and the reason for that it obvious. Since the early 1980s, a rapidly growing share of the money creation has gone into the financial markets, propelling in particular share prices, instead of goods prices. In 2001, though, a completely new pattern has developed. Money creation is running at top speed, yet economic growth has stalled, while formerly rampant wealth creation through the booming stock market has reversed into massive wealth destruction through plunging stock prices. Where is all the money going? There is but one single explanation: It reflects a dramatic change in liquidity preference.

Expressing it in popular technical jargon: the soaring money supply evaporates in sharply declining *money velocity*, more than offsetting the exploding credit and money expansion, thereby robbing them of their regular economic and financial effects.

Unfortunately, this terminology, tending to suggest that consumers spend their income more rapidly, obscures more than clarifies the relevant underlying causality. Irving Fisher, in particular, popularized this concept of *money velocity*, replacing the far more insightful so-called *"cash-balance"* concept of the Cambridge school in Britain (Marshall, Pigou, Robertson, Keynes etc.). By focusing on changes in the demand for money (Keynes: liquidity preference), it looked into the relevant, underlying motivation and causality.

But Fisher, too, had stressed something that today's monetarists have completely lost sight of: *"We emphasize the fact that the strictly proportional effect of an increase in M on prices is only the* ***normal or ultimate effect after transition periods are over,****"* he wrote. This statement was akin to the statement of one of the earliest writers on money, John Stuart Mill, that money exerts significant effects on the economy only when it is "out of order." For the old economists, including Irving Fisher, such "periods of transition" when money went "out of order" were the thing that really matters and that requires close study. These "periods of transition" are, in actual fact, the typical aftermath of a runaway boom.

As *dramatic* changes in money velocity are a particularly rare occurrence in history, it is the most neglected monetary feature. Yet they can happen with unbelievable vengeance. In 1930, a ferocious plunge in U.S. GDP growth by 9% coincided with a minimal shrinkage in the money stock by just 0.9% but a steep decline in money velocity by 13%. Manifestly, it was the collapse of velocity, rather than the minimal decline in the money stock, that must be held responsible for the start of the Depression.

Collapsing money velocity is, in actual fact, the outstanding typical feature of every severe economic crisis, just as its sharp acceleration is typical of every runaway boom. But what is it that triggers such changes, and how do they come about?

What exactly is happening in the financial system when money *velocity* collapses? In short, it inherently reflects a general attempt to replenish money balances (liquidity) following a prior depletion during the boom. Remember the former Wall Street slogan: Cash is trash. People want to increase the share of "available money" in their portfolios, and that was the idea behind the "cash-balance" concept of the Cambridge school.

Essentially, the length and intensity of such a rush for liquidity are largely predetermined by the scope of financial dislocations that have accumulated during the prior boom and need correction. In 1930, the collective efforts to become more liquid in this way again ended in total illiquidity as the banking system failed to create the necessary new money.

WHAT LIQUIDITY?

It needs no explanation that today's Fed is desperate to prevent the recurrence of such a self-feeding rush for liquidity, and in contrast to the Fed of 1930, it appears to be highly successful in providing the flow of new money that meets the apparently soaring demand for it. For the consensus, the money supply figures are compelling proof of the monetary easing's initial success. Not for us.

GDP, MONEY AND CREDIT GROWTH, 1996-2001 (IN $BILLION)					
	GDP*	M2	M3	Nonfinancial Private Credit	Financial Credit
1996	412.7	172.5	346.0	586.3	545.7
1997	505.2	216.2	459.3	781.5	653.8
1998	471.8	353.0	599.5	1,064.0	1,073.9
1999	509.0	266.6	499.5	1,160.0	1,077.2
2000	663.9	293.3	571.5	1,158.5	801.8
2001 Q1	115.0**	157.3	231.8	976.3**	873.6**

** billion of current dollars, ** annualized*

In 1930, the economy and the stock market collapsed in the face of a stagnant money stock. In 2000, the dramatic downturn of the stock market and the economy has taken place in the face of soaring broad money growth. Like in 1930, this divergence is the conspicuous manifestation of a sharp decline in money velocity, in other words, of a general rush for higher liquidity.

In the first place, these figures make shambles of the general notion that the ailments in the economy and the stock markets have come from tight money. The economy and markets have crashed against the backdrop of a deluge of money and credit creation. Next, please take a look at the numbers for the first quarter of 2001. Annualized nominal GDP growth of $115 billion compares with M3 growth of $231.8 billion and annualized total debt growth of $1,832.1 billion. For each dollar added to GDP there was more than $15 added to indebtedness (in current dollars). We think it's a horror story. Where is all that borrowed money going?

We see big outlets for the continuing borrowing and lending binge that leave GDP untouched; *first,* about half of that credit orgy is financial credit financing leveraged bond purchases; *second*, the consumer has to step up his borrowing in order to compensate for shrinking income growth; *third*, huge amounts of borrowed money vanish in house price inflation; and *fourth*, corporations borrow heavily to compensate for sharply lower cash flow and rising losses. The U.S. debt colossus has become addicted to permanent, unfettered additions of financial leverage just to stay upright.

In short, Mr. Greenspan is heavily pushing on a string. Putting it differently, demand for money is increasing faster than its rapidly rising supply. This is, actually, the specific phenomenon that tends to thwart monetary easing. In 1930, the race for liquidity ushered in a self-feeding adjustment process that spiraled into the Great Depression. Currently, money growth of more than 13% compares with nominal GDP growth of barely 3%. Principally, it's the same relationship. The difference lies in today's rampant money creation. But lately most of it — see the chart on page 8 — comes from a source that has minimal or no leverage on the economy and the markets. It's the money market funds.

How does the money creation through this channel come about? Wanting to keep funds liquid at a better yield than they get on bank balances, an investor puts some funds into money market fund deposits. He writes a check on his bank deposit and mails it to the management of the fund. What happens? While he abandons his bank deposits, they nevertheless continue to exist in full amount at his bank. But their ownership has changed. The new owner is the money market fund, which, in exchange, has incurred a corresponding, quickly callable liability to the investor, who regards it as part of his money balances. He personally has created this money.

As this kind of money creation is lately accounting for more than 60% of its total, this raises the question of its effects on the economy and the markets. Their balance sheets give the answer. In order to earn the interests to service their liabilities, the money market funds purchase corresponding amounts of better-yielding short-term financial assets. Between Q1 2000 and Q1 2001, an increase in liabilities by $328.7 billion was matched on the asset side by a diversity of investments in Security RP's, Treasury bills, Agency Bonds, Municipal Securities and Corporate Bonds. How much of these investments went ultimately into the economy's spending and income stream, adding to GDP growth? We doubt any of it. We are inclined to call it barren money creation, reflecting primarily a generally rising risk aversion and liquidity preference.

There is still another important difference between a balance held at a bank and one held at a money market fund. Only bank deposits are a means of payment; balances at money market funds are not. If its owner wants to make a payment, he has to convert it back into bank deposits, and in order to implement this transfer, the money market fund has to sell a corresponding amount of his asset holdings.

Now to the money creation of the banking system. The asset side of the banks' balance sheets puts the fundamental difference into focus. The main outlets of lending are commercial and industrial credit, consumer credit, real estate credit, and government and corporate bonds. Most of this money and credit creation feeds directly into the economy's spending and income stream. Bank lending in the first half of 2000 has expanded at an annual rate of $435 billion. But in the fourth quarter of 2000, it was down to $146 billion, and in the first quarter of 2001 to $166 billion, all at annual rates. The bankers have drastically retrenched.

EURO TROUBLE, DOLLAR BUBBLE

A few weeks ago, Intel's CEO stated: "America has pneumonia, Europe has a cold." Reading the international media, however, one gets the exact opposite impression. Any data indicating economic weakening in one of the 11 countries of the euro area finds tremendous publicity. Courtesy of the *London Economist:* "*After irrational exuberance, a rude awakening as new-wave and old-style enterprises alike are suffering from stunted growth,*" proclaimed *Time* magazine the other day. A comment on how America's boom turned to bust? Far from it: The article was about economic trouble in Europe. Far more horrible news about the U.S. economy is buried under the universal, uncritical applause for the Fed's vigorous rate cuts and related euphoric growth forecasts. It is just as readily ignored that these rate cuts have miserably failed to have any effect even in the financial markets.

The Bank for International Settlements writes in its just published annual report: "*The dollar's renewed strength vis-à-vis the euro in early 2001 was particularly puzzling in the light of the unexpectedly sharp slowdown in the United States and associated monetary easing.*" In actual fact, the dollar had plunged against the euro in late 2000 within a few weeks by about 15%; but it turned up again after the Fed started its first big rate cut in early January. At the very least, this testifies to the dollar's vulnerability to bad news. Since then, though, the endless stream of surprisingly bad news is being overwhelmed by the entrenched false optimism about longer-term U.S. economic growth. Expecting returns to remain higher in America than at home, European corporations and investors are investing like mad in America, the former in stocks, the latter in bonds. During the first four months of 2001, the euro zone suffered a net outflow of investment of more than €100 billion, more than twice the level recorded in the same period of 2000.

False optimism about the U.S. economy is one obvious reason for the dollar's puzzling strength. The other, big negative influence comes from European policymakers, European Central Bank officials in particular. Their policy is in reality far better than their reputation. Europe has none of the major economic and financial imbalances that are sure to turn the U.S. economy's downturn into a deep, protracted recession.

America's superior economic performance in the past several years owed everything to the wonders of a bubble economy and nothing to the trumpeted profit and productivity wonders. But as far as public relations are concerned, the European policymakers were simply too naïve and too honest in comparison to their American counterparts.

Their worst single policy blunder is their demonstrative equanimity towards the falling euro. Many remarks from ECB President Willem Duisenberg and others could not fail to create the impression that they rather liked it as an apparent stimulant to EU exports. But what fits a small country like the Netherlands does not fit a large area like the euro zone. For Europe as a whole, the potential gains for the small export sector from the weak currency are vastly inferior to the negative effects of sharply higher import prices on consumer purchasing power and business costs.

There is for us no question that the weak euro has done far more to strangle Europe's economy than to stimulate it. During the two years from 1998 to 2000, Germany's imports increased in current prices by DM 105.8 billion, but only by DM 57 billion in real terms. The difference between the two equaled 30% of nominal

GDP growth. By this measure, the drastic deterioration in the terms of trade was the main brake on economic growth in Europe. Apparently, not one policymaker in Europe has grasped this, not to mention the further fact that the resulting higher domestic inflation rates prevent the central bank from prompter monetary easing. Import price inflation is equally the main reason why the euro zone's current account during these two years went from a surplus of €31 billion in 1998 to a deficit of €34 billion in 2000.

The only possible explanation of the dollar's persistent strength is the prevalent false optimism about the U.S. economy's vigor and misplaced gloom about Europe's economic sclerosis. European corporations and institutional investors are massively buying the U.S. economy's recovery that according to U.S. policymakers and Wall Street gurus is just around the corner, readily financing and overfinancing the $400 billion U.S. current-account deficit. In these hectic markets, anticipation runs ahead of events as never before. As to what we expect to happen, we refer to the introductory quote on the first page: "By late summer..." Among the big financial problems to erupt suddenly with a vengeance will be the huge current-account deficit. As capital inflows sharply slow down, the dollar's decline will soon turn into a steep slide. It will boost U.S. inflation, but above all it will play havoc with the U.S. financial markets. A weak dollar is, therefore, the nightmare of policymakers around the world.

CONCLUSIONS:

Global economic news is depressing all around with weakening data from all continents. Superficially, it may look like the crisis of 1998, which was so easily solved by a few U.S. rate cuts. In reality, the contagion is very different. In 1998, it was a mere confidence game about financial capital fleeing from non-Japan Asia and Russia. This time, the contagion's center is the bursting U.S. bubble economy.

Investors have readily embraced the story of the U.S. economy's impending V-shaped recovery. They put great hope in the exploding broad money growth. But as we have explained, the money flooding into the money market mutual funds is idle money that cannot be spent.

Basically, the U.S. economy's economic and financial fundamentals are the most rotten in history, worse than in 1929-30. The portents are for a Japanese-style L-shaped recession. The storm will hit the dollar and the U.S. financial markets with full force.

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